

BUILDING VALUE

SUCCESS THROUGH COLLABORATION

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THE “VALUE” OF “INVESTMENTS” IN ACCOUNTS RECEIVABLE AND INVENTORY

The classic definition of net cash flow, or net free cash flow is:

Net income

Plus: Depreciation and Amortization
(usually a plus)

Plus or Minus: Net Change in Working
Capital

Less: Capital Expenditures

Equals: Net free cash flow

Interestingly, net income, depreciation and amortization, and the net change in working capital appear in the operating

section of the cash flow statement.

Capital expenditures appear in the investment section. (Never mind changes in long-term debt for now)

The implication is that working capital is an operating issue and not an investment issue. But nothing could be further from reality in a valuation sense.

Increases in accounts receivable and inventory, the major asset components of working capital, absorb cash flow that would otherwise be available for

investment or distribution. These elements can have a particularly significant impact when an enterprise is experiencing unusually high growth or when the economy slows and customers are slow in converting their accounts receivable obligations to cash.

In a sense, working capital increases are investments much like capital expenditures. Funds deployed to working capital should provide appropriate incremental returns, just like investments

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CASE UPDATE — JELKE V. COMMISSIONER

Estate of Jelke et al v. Commissioner, 05-15549, US Court of Appeals for the 11th Circuit, November 15, 2007

The Eleventh Circuit overturned the Tax Court and allowed the estate a dollar-for-dollar reduction in fair market value for the hypothetical tax on trapped-in gains for a “C” corporation minority shareholder.

Decedent owned 6.44% of the common stock of Commercial Chemical Company (CCC), a “C” Corporation. CCC is a holding company whose primary asset was securities. The market values of these securities exceeded the underlying tax bases by \$51 million. Based on the historical portfolio turnover, the Tax Court had assumed the tax on trapped-in gains would be paid over 16 years, and applied a present value calculation to the tax.

The Eleventh Circuit reviewed all of the prior trapped-in gains cases in the various Circuits. It also cited an article by a Financial Consulting Group member in *The Montana Lawyer* that had been previously cited by the Second Circuit in *Eisenberg*. The Court discussed the lack of any plan to liquidate CCC and the inability of a minority shareholder to force a liquidation, but found those factors unpersuasive.

The Court noted: “The rationale of the Fifth Circuit in the *Estate of Dunn* eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation. The *Estate of Dunn*

dollar-for-dollar approach also bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions. The *Estate of Dunn* has the virtue of simplicity and its methodology provides a practical and theoretically sound foundation as to how to address the discount issue... This 100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena. We thereby follow the rationale of the Fifth Circuit in the *Estate of Dunn*, that allows a dollar-for-dollar, \$51 million discount for contingent capital gains taxes...”

— *John Gilbert, CPA/ABV, ASA*

*“Value of Investments”
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in machinery, equipment, or other productive assets.

While it may seem obvious that dollars deployed to working capital are “investments,” I do not believe that dollars “spent” on working capital get the same degree of scrutiny as capital expenditure dollars.

Let’s look at a company, a successful distribution company. The company grew rapidly and profitably over several years, but generated little free cash flow. There have been no dividends, modest share repurchases, appropriate capital expenditures, and massive “investments” in working capital, primarily accounts receivable and inventory.

Of note, the income statement revealed a significant increase in interest expense, attributable both to increased volume of borrowings (to fund accounts receivable and inventory growth) and to increases in borrowing costs.

The increased interest costs were swamped by sales growth and good operating margins. But the cost of funds generated considerable discussion by the board. As it turns out, the company’s operating managers considered investments in accounts receivable and inventory as virtually “free.”

But are such working capital investments “free”? At the margin, every dollar not “invested” in working capital is available to reduce borrowings or to make distributions to shareholders. And, every dollar not “invested” in working capital enhances earnings by reducing the cost of carrying inventory and receivables. And, every dollar of reduced



carrying costs in a rising rate interest rate environment helps to preserve business value. From 2003 to 2006 the prime rate increased from 4% to 8.25%. Given the current low rates we could soon find ourselves in another period of rising rates.

Consider the following example. A profitable, \$50 million sales company borrows against its accounts receivable and inventory to support its operations. It is borrowing at the maximum of its credit facility, or 80% of accounts receivable plus 50% of inventory, for a total amount of borrowings of \$10.3 million. This hypothetical company borrows at a rate of 8.25%.

With this hypothetical company, inventory is turning over 5 times per year, and accounts receivable days outstanding sit at 60 days. Assume that there is room for improvement of both the inventory and receivables turnover ratios, but we’ll hold these ratios constant for this example.

Assume further that this company would be valued at a multiple of 5x pre-tax income, which was \$4.6 million when prime was 4%. The company’s value, under the above assumptions, was \$22.9 million. Now, let’s hold all other assumptions constant, and see what happens to earnings and value as the prime rate increased.

Other things being equal, this company has declined in value from \$22.9 million to \$20.7 million with the increase in prime rate between mid-year 2004 and mid-year 2006, or about 10% — or \$2.2 million!

Assume that this company could reduce its investment in inventory and accounts receivable by better focus and management by \$1.0 million. Borrowings could be reduced by that amount, and the interest expense on those borrowings could also be eliminated.

When the prime rate was 4%, the value impact of \$1.0 million in working capital borrowings was \$200 thousand, or less than 1% of overall equity value. At a prime rate of 8.25%, that value impact is \$413 thousand, or about 2% of value. If the prime rate should return

“Small changes in working capital management can have a significant impact on earnings and on business value.”

to 11%, the value impact rises to about 3% of equity value.

To get to the bottom line of this analysis, a couple of observations are appropriate:

1. Small changes in working capital management can have a significant impact on earnings and on business value. As Everett Dirksen once said: “a billion here and a billion there, pretty soon you’re talking about real money.” Well, a little bit here and a little bit there pretty soon adds up to real value!

2. One last perspective. At an 8.25% prime rate, for every dollar of reduced borrowings achieved through better operations, 41 cents translates into increased value.

— Mercer Capital



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